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In the Supreme Court of the United States

OCTOBER TERM, 1948

No. —

OMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

PHILADELPHIA TRANSPORTATION COMPANY

TITION FOR A WRIT OF CERTIORARI TO THE NITED STATES COURT OF APPEALS FOR THE HIRD CIRCUIT

The Solicitor General, on behalf of the Commis-ner of Internal Revenue, prays that a writ of rtiorari issue to review the judgment of the urt of Appeals for the Third Circuit entered in above-entitled cause on March 21, 1949.

OPINIONS BELOW

The opinion of the Tax Court (R. 17-37) is re-rted at 9 T. C. 1018. The opinion of the Court Appeals (R. 97-100) is not yet officially reported.

JURISDICTION

The judgment of the Court of Appeals was en-ed on March 21, 1949. (R. 101.) The juris-tion of this Court is invoked under 28 U.S.C., ction 1254.

QUESTION PRESENTED

A corporate taxpayer came into existence on January 1, 1940 as a result of the merger and consolidation of a number of old companies, and on January 29, 1940, issued bonds dated January 1, 1939, purporting to bear interest from the latter date, in exchange for assets of the predecessor companies. In 1940 the taxpayer paid the bondholders a sum of money purporting to be "1939 interest" on its bonds. Is the taxpayer, which computes its taxes on the accrual basis, entitled, under Section 23(b) of the Internal Revenue Code, to deduct from its 1940 income as "interest" the sum so paid?

STATUTE AND REGULATIONS INVOLVED

The pertinent provisions of the statute and regulations are printed in the Appendix, *infra*, pp. 8-10.

STATEMENT

The facts are not in dispute and, as found by the Tax Court (R. 18-34), may be summarized as follows: The taxpayer came into existence on January 1, 1940, pursuant to a reorganization under the Bankruptcy Act, the plan of which, as approved by the District Court, merged and consolidated 65 preexisting companies into a new company, the taxpayer. (R. 19, 21-22, 25.) On January 29, 1940, as part of the plan, the new company issued to holders of stock and stock trust certificates and to certain holders of bonds of the old companies its 99-year consolidated mortgage bonds. (R. 20.) These bonds were dated Janu-

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ary 1, 1939, and bore "fixed interest" and "income interest" from that date.[1] (R. 20-21.) Simultaneously with the issuance of bonds, the taxpayer delivered to the trustee for the bondholders its check for the "fixed interest" for 1939. (R. 26-27.) On July 1, 1940, the taxpayer paid "income interest" for 1939, at the rate of 2.52%. (R. 30-31.) The two payments of "1939 interest" aggregated about $1,787,000. In 1940, the taxpayer showed a substantial loss, which was carried over. (R. 34.) In determining the taxpayer's net operating loss carry-over for 1942, the Commissioner disallowed the deduction of the "1939 interest" for 1940, giving rise to the deficiency involved in this case.[2] (R. 32.) The taxpayer kept its books and filed its tax returns on the accrual basis. (R. 18.) The applicable section of the statute permits the deduction of "all interest paid or accrued within the taxable year on indebtedness." Internal Revenue Code, Section 23(b).

The Tax Court, upon petition by the taxpayer, held that "the petitioner properly accrued and deducted in its income tax return for 1940, interest

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[1] "Fixed" interest of 3% was payable in any event; an additional 3% "income" interest was payable "only if and to the extent to which earned" in any year. (R. 20-21, 48; Ex. 7-G, pp. 71-73.)

[2] The taxpayer also deducted the amount which it paid the bondholders in 1940 and 1941 as fixed and income interest for 1940. This deduction was allowed by the Commissioner and is not in issue in this proceeding (R. 31) except to the extent that it is relevant to the question of the propriety of the deduction by a taxpayer on the accrual basis of "interest" for two years in a single year.

in the amount of $1,787,206.88 which it paid in that year." (R. 34, 37.) The Court of Appeals affirmed, one judge dissenting. (R. 97-100.)

REASONS FOR GRANTING THE WRIT

1. As both the Tax Court and the Court of Appeals recognized, the decision is in conflict with that of the Court of Appeals for the Seventh Circuit in *Commissioner* v. *Drovers Journal Pub. Co.*, 135 F. 2d 276. (R. 35, 36, 99, fn. 5.) In that case, a corporation issued, on December 7, 1937, notes bearing interest from January 1, 1937, in exchange for preferred stock of its parent corporation. On December 29, 1937, it paid the noteholders $28,000, representing "interest" from January 1, 1937, and sought to deduct this amount in its income tax return for 1937, under Section 23(b) of the Revenue Act of 1936 (49 Stat. 1648), which corresponds to the present Section 23(b) of the Code. The taxpayer had kept its books and made its returns on the accrual basis. The Commissioner disallowed so much of the "interest" deduction as was attributable to the period between January 1 and December 7. The Tax Court held that the entire $28,000 constituted deductible interest. The Court of Appeals reversed, on the ground that "interest", as used in the statute, means "the amount which one has contracted to pay for the use of borrowed money," and that "since no indebtedness was owing by the respondent * * * prior to December 7, 1937, the $28,000 could not be paid as compensation for pre-December 7 use

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of the $400,000 borrowed on the notes." 135 F. 2d at 278-279. Cf. *Old Colony Railroad Co.* v. *Commissioner,* 284 U.S. 552; *Deputy* v. *Dupont,* 308 U.S. 488, 497. In the present case, the Court of Appeals has sanctioned the deduction of "interest" paid for a period when no indebtedness existed. The conflict is obvious.

2. The dissenting judge in the instant case took the position that the so-called 1939 interest "was not a payment of 'interest' but was merely a part of the consideration for the acquisition of the assets acquired in part therewith, and as such was a capital investment rather than rent for the use of money or its equivalent." (R. 100.) A similar view is implicit in the holding of the Court of Appeals for the Seventh Circuit in *Commissioner* v. *Drovers Journal Pub. Co., supra.* Compare *Pratt-Mallory Co.* v. *United States,* 12 F. Supp. 1020 (Ct. Cl.), which seems also to be in conflict with the instant case. There the taxpayer purchased a business in July, 1925, for a stipulated sum plus "interest" from December, 1924. The court held that the so-called interest was really part of the cost of the property and hence not an allowable deduction from income.

A number of aspects of the present transaction, which are at least anomalous if the payments here concerned are regarded as interest, are readily comprehensible on the hypothesis that the "1939 interest" was simply part of the consideration which the taxpayer paid for its assets. Thus, the

payment of the 1939 "fixed interest" coincided with the issuance of the bonds; the transaction amounted to the delivery of cash and long-term bonds in exchange for assets.[3] Similarly, some of the "1939 interest" plainly amounted to a payment by the taxpayer of the obligations of its predecessor companies—*i.e.*, obligations which it had assumed as part of the purchase price of their assets. Thus, the "income interest" for 1939 could not properly have been paid as an obligation of the taxpayer itself, for it had no income in 1939 and so would have been precluded from paying such interest by the terms of the reorganization plan. (R. 20-21, 48.) Likewise, in cases in which predecessor companies had paid interest on their bonds for the first half of 1939, the taxpayer, when it issued its new bonds in exchange for the old ones, removed Fixed Interest Coupon No. 1—*i.e.*, treated payment by the old companies of part of the 1939 interest due on their bonds as a discharge pro tanto of the taxpayer's obligation to pay "1939 interest" on its bonds. To the extent that the taxpayer has been permitted to deduct as "interest" under Section 23(b) sums which it paid in discharge of the liabilities, accrued before the consolidation and merger, of its predecessor companies, the decision below is in conflict with the holding of the Court of Appeals for the Second

[3] It is significant that, in accordance with regulations of the Pennsylvania Public Utility Commission, the taxpayer's payments in 1940 of "1939 interest" were not charged as an expense in the taxpayer's accounts for 1940. (R. 31.)

Circuit in *Rodney, Inc.* v. *Commissioner,* 145 F. 2d. 692.[4]

3. The question here presented is of great practical importance in the administration of the Internal Revenue Code. As is shown by the cases cited and discussed by the court below, it has frequently been raised in the past; it is involved in four pending cases besides the present one; and it may be expected to arise frequently in the future, unless resolved by this Court.

CONCLUSION

The decision below is wrong and is in conflict with decisions in other circuits. The question is a recurring one and of general importance. For the foregoing reasons, the petition for a writ of certiorari should be granted.

Respectfully submitted,

PHILIP B. PERLMAN,
Solicitor General.

JUNE 1949.

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[4] In the *Rodney* case, the taxpayer corporation acquired all the assets of a subsidiary, which it dissolved, and assumed all its obligations. Thereafter, the taxpayer paid interest which had accrued on the bonds of the dissolved company and attempted to deduct the sum so paid as interest on its own tax return. The Court of Appeals held that the taxpayer's assumption of the subsidiary's liabilities in exchange for its assets was a "capital transaction" and that interest paid by the taxpayer, which had accrued before the purchase, was not "interest" within the meaning of Section 23(b).

APPENDIX

Internal Revenue Code:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * *

(b) *Interest.*—All interest paid or accrued within the taxable year on indebtedness * * *.

* * * * *

(s) [as added by Section 211 (a) of the Revenue Act of 1939, c. 247, 53 Stat. 862.] *Net Operating Loss Deduction.*—For any taxable year beginning after December 31, 1939, the net operating loss deduction computed under section 122.

(26 U.S.C. 1946 ed., Sec. 23.)

SEC. 43. PERIOD FOR WHICH DEDUCTIONS AND CREDITS TAKEN.

The deductions and credits (other than the corporation dividends paid credit provided in section 27) provided for in this chapter shall be taken for the taxable year in which "paid or accrued" or "paid or incurred", dependent upon the method of accounting upon the basis of which the net income is computed, unless in order to clearly reflect the income the deductions or credits should be taken as of a different period. * * *

(26 U.S.C. 1946 ed., Sec. 43.)

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SEC. 122 [as added by Section 211 (b) of the Revenue Act of 1939, *supra*]. NET OPERATING LOSS DEDUCTIONS.

(a) [as amended by Section 105 (e)(3)(A) of the Revenue Act of 1942, c. 619, 56 Stat. 798] *Definition of Net Operating Loss.*—As used in this section, the term "net operating loss" means the excess of the deductions allowed by this chapter over the gross income, with the exceptions, additions, and limitations provided in subsection (d).

(b) [as amended by Section 153 (a) of the Revenue Act of 1942, *supra*] *Amount of Carry-Back and Carry-Over.*—

* * * * *

(2) *Net operating loss carry-over.*—If for any taxable year the taxpayer has a net operating loss, such net operating loss shall be a net operating loss carry-over for each of the two succeeding taxable years, except that the carry-over in the case of the second succeeding taxable year shall be the excess, if any, of the amount of such net operating loss over the net income for the intervening taxable year * * *.

* * * * *

(26 U.S.C. 1946 ed., Sec. 122.)

Treasury Regulations 103, promulgated under the Internal Revenue Code:

SEC. 19.43-2. *When charges deductible.*—Each year's return, so far as practicable,

both as to gross income and deductions therefrom, should be complete in itself, and taxpayers are expected to make every reasonable effort to ascertain the facts necessary to make a correct return. The expenses, liabilities, or deficit of one year cannot be used to reduce the income of a subsequent year. A taxpayer has the right to deduct all authorized allowances, and it follows that if he does not within any year deduct certain of his expenses, losses, interest, taxes, or other charges, he cannot deduct them from the income of the next or any succeeding year. * * *.

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